# BOARD OF AUDITORS

European Stability Mechanism

Annual Report to the Board of Governors
for the period ended 31 December 2014

# 1. Introduction

The Board of Auditors of the European Stability Mechanism (further referred to as the “ESM”) is established pursuant to Article 30 of the Treaty establishing the ESM and Article 24 of the ESM By-Laws. The Board of Auditors is independent from the Board of Directors and its members are appointed directly by the Board of Governors.

The Board of Auditors carries out independent audits, inspects the ESM accounts, audits regularity, compliance, performance, risk management and monitors as well as reviews the ESM’s internal and external audit processes and their results.

This report is addressed to the Board of Governors in accordance with Article 24 (6) of the ESM By-Laws and provides details on the audit work of the Board of Auditors, its audit findings in relation to the financial statements of the ESM and its conclusions and recommendations for the period from 1 January to 31 December 2014. This report will be made available also to the national parliaments and supreme audit institutions of the ESM Members, to the European Court of Auditors and the European Parliament.

The members of the Board of Auditors were appointed by the Board of Governors as follows:

- Mr Marc Gengler, nominated by the Supreme Audit Institution of the Grand Duchy of Luxembourg
- Mr Ulrich Graf, nominated by the Supreme Audit Institution of the Federal Republic of Germany
- Mrs Katarína Kaszasová, upon the proposal of the Chairperson of the Board of Governors
- Mr Igors Ludboržs nominated by the European Court of Auditors
- Mr Jules Muis, upon the proposal of the Chairperson of the Board of Governors.

The initial members of the Board of Auditors were appointed for a non-renewable term of three years on 8 October 2012, except for Ms Kaszasová and Mr Graf whose names were drawn by lot and were appointed for a non-renewable term of four years until October 2016 to ensure continuity of the work of the Board of Auditors. New members of the Board of Auditors are appointed for non-renewable terms of three years.

The Board of Auditors elected Ms Kaszasová as Chairperson and Mr Graf as Vice-chairperson, both for the term from March 2014 until October 2014.

On 8 October 2014 the Board of Auditors elected Mr Graf as Chairperson and Mr Ludboržs as Vice-chairperson for a one-year term lasting until 8 October 2015.

At the time of their appointment and during the performance of their duties, the members of the Board of Auditors took care to avoid all conflicts of interest and have refrained from any action incompatible with their duties. The members of the Board of Auditors acted independently and have not sought or taken instructions from the ESM governing bodies, the ESM Members or any other public or private body.

# 2. Activities of the Board of Auditors

## 2.1. MEETINGS OF THE BOARD OF AUDITORS

The Board of Auditors held 9 meetings in 2014. The purpose of these meetings was to be briefed by and to discuss with ESM's management developments and oversight questions. These were in particular relating to the Board of Auditors core missions:

- the assuring of the integrity and adequacy of the financial statements and the related controls frameworks as well as
- the performance of selective efficiency and effectiveness reviews.

Additionally the Board of Auditors met once with the ESM Board of Directors in June 2014. In the same month, subsequently the Chairperson of the Board of Auditors attended the annual meeting of the Board of Governors and met with the Chairperson of the Board of Governors.

During their meetings the Board of Auditors received regular updates on the activities of the ESM and the ESM governing bodies, attended presentations by management on specific topics requested by the Board of Auditors and met with the internal auditor and the external auditor.

From 31 December 2014 to the date of this report, the Board of Auditors held a further 4 meetings.

## 2.2. SCOPE

The Board of Auditors has:

- performed limited review procedures in accordance with Article 30 (3) of the ESM Treaty and Article 24 (4) of the ESM By-Laws focusing, among other subjects, on the review of risk management governance and policies, ESM's lending operations, the transitional investment portfolio, the ESM rating, the direct bank recapitalisation project and the ESM accounting framework;
- reviewed whether, and in how far, recommendations arising from the 2013 Annual Report to the Board of Governors were considered and implemented;
- reviewed the ESM financial statements for the period ended 31 December 2014 as drawn up and adopted by the Board of Directors on 25 March 2015. The ESM's Financial Statements were prepared and presented in accordance with the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006; the Directive 2006/46/EC has been amended by Directive 2013/34/EU. The ESM applies the same transitional period applicable to the Member States for transposition by 2016;
- noted that in accordance with the aforementioned financial statements, the balance sheet totals as at 31 December 2014 amount to EUR 753 billion and consist on the assets side mainly of loans and advances to euro area Member states (EUR 45 billion), debt securities (EUR 62 billion), subscribed capital called but not paid (EUR 177 million) and subscribed ("authorized" according to Article 8 of the Treaty establishing the ESM) capital not yet called and unpaid (EUR 622 billion). The total own funds amount to EUR 703 billion and liabilities are composed mainly of debts evidenced by certificates (EUR 49 billion). The net profit for the financial year amounts to EUR 444 million, mainly the result of interest receivable and similar income (EUR 710 million), interest payable and similar charges (EUR 349 million), net profit on financial operations (EUR 103 million) and general administrative costs (EUR 41 million);
- monitored and reviewed external audit processes performed by PricewaterhouseCoopers, Société coopérative, Luxembourg (further referred to as "PwC");
- met members of the Management Board including the ESM Managing Director and the Secretary General, Heads of Corporate Governance & Internal Policies, Finance and Control, Banking, Investment and Treasury, Chief Risk Officer, Internal Auditor and other members of ESM's management and discussed as well as reviewed relevant issues and developments;
- monitored and reviewed the internal audit processes and its results according to Article 24 (4) of the ESM By-Laws;
- received at its request various written representations from the ESM Management Board members and members of the ESM's management concerning issues of oversight interest.

# 3. Follow up of 2013 Board of Auditors Annual Report to the Board of Governors

The Board of Auditors invited the Board of Governors to consider findings and recommendations mentioned in its 2013 Annual Report and to undertake appropriate initiatives.

Based on its own independent audits as well as ongoing work:

- The Board of Auditors observed during the year 2014, and in the subsequent months up to the signing of its 2014 Annual Report, that further progress has been made in the development and implementation of standard practice controls. In this respect ESM has set up a roadmap for its internal control framework. The Board of Auditors notes that the ESM continues to develop further a system of internal controls which is consistent with the nature, complexity and the risk inherent with its activities.

- In particular the Board of Auditors again draws attention to the still ongoing development of the adequacy and acceptability of the ESM's financial controls and its Financial Reporting.

- The Board of Auditors noted that the ESM made progress in implementing adequate risk management. Nevertheless there is room for improvement as specified in paragraph 4.4.

- The Board of Auditors welcomes that the ESM, based on the Board of Auditors´ 2012 recommendation, reassessed in 2014 the ESM's chosen accounting frame of reference (the EU accounting and Banking Directives), as "fit for purpose". The Board of Auditors discussed this analysis at several meetings and recommended a continuous reassessment of the ESM accounting framework. The Board of Auditors notes that according to the Regulation (EC) No 1606/2002 it is important that the financial reporting standards applied by EU companies participating in financial markets are accepted internationally and are truly global standards, namely International Financial Reporting Standards (IFRS).

- The Board of Auditors reiterates its strong recommendation that the ESM adopts the EU regulatory framework as its own. For example ESM procurement policies are still not aligned with EU public procurement policies.

The findings and recommendations related to the internal and external audits as well as to the Board of Auditors own audits are presented and commented in the following sections of this report.

# 4. Findings and Recommendations

## 4.1. FINANCIAL STATEMENTS 2014

In accordance with the ESM By-Laws, Article 23 (2) (d) the Board of Auditors reported, in its separate Report on Financial Statements, the following:

"In 2014 the ESM has made further progress in design and implementation of internal, operational and managerial controls. The institution is still in the process of introducing a comprehensive integrated controls framework that should finally enable ESM Management to confirm the adequacy and effectiveness of the internal controls as a whole. The Board of Auditors notes that, to the best of its judgment, no other material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the year ended 31 December 2014."

Based on knowledge obtained from exchanges of view with the ESM's management and the external auditors as well as based on publicly available information, the Board of Auditors is not aware of any significant subsequent events to be recognized in the ESM financial statements for the period ended 31 December 2014.

## 4.2. EXTERNAL AUDIT

In accordance with the ESM treaty, Article 29 "Accounts of the ESM shall be audited by independent external auditors approved by the Board of Governors and responsible for certifying the annual financial statements".

The ESM financial statements for the year ended 31 December 2014 were again audited by PwC. The external auditor was appointed as "réviseur d´entreprises agréé" (statutory auditor) by the ESM Board of Governors on 8 December 2014. The engagement letter was signed by the ESM representatives on 19 December 2014. Based on this engagement letter, PwC was requested to carry out a statutory audit of the financial statements of the ESM for the year ending 31 December 2014 in accordance with International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier" (further referred to as "CSSF"), the Luxembourg legislation, the professional standards adopted by CSSF and the professional standards issued by the "Institut des Réviseurs d´Entreprises".

PwC issued an unqualified Auditor's opinion on 27 March 2015 stating that "In our opinion, the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2014, and of the results of its operations and its cash flows for the year then ended in accordance with the general principles of the Directives."

In accordance with the ESM By-Laws, Article 24, (4) "It (Board of Auditors) shall monitor and review the ESM's internal and external audit processes and their results".

The Board of Auditors has met the PwC representatives several times; reviewed documentation prepared by PwC and discussed the auditor's strategy and planning, interim results and the closing of the audit.

The Board of Auditors brings to Board of Governors' attention the following:

- The ESM followed the Board of Auditors' recommendation in 2012 and 2013 to conduct a competitive procurement process for the selection of the external auditor of the ESM financial statements.
- The Board of Auditors observed the process of procurement for the external auditor.
- Following the Board of Auditors' former recommendation PwC granted the Board of Auditors for the first time full access to the external audit working papers during a five-day review at the PwC premises in Luxembourg. This review allowed to conclude that the audit documentation prepared by PwC, in respect of the ESM financial statements for the year ended 31 December 2014, was sufficient to enable to understand the audit work done.
- The Board of Auditors reiterates its former recommendation to expand the external auditor's mandate to include a long form report, e.g. covering risk management as well.
- The Board of Auditors takes note of PwC's "special topic report" as part of the management letter covering the internal controls in place with respect to the production of the year-end financial statement as well as the ESM's management reporting system. Nevertheless this cannot be seen as a substitute for a long form report.
- The Board of Auditors takes note of PwC's management letter and encourages ESM's management to follow up on their findings and recommendations.

## 4.3. INTERNAL AUDIT

The ESM Treaty, Article 28 stipulates: "An internal audit function shall be established according to international standards". Additionally, Article 24 (4) of the ESM By-Laws requires: "It (the Board of Auditors) shall review the ESM's internal and external audit processes and results".

Following a recommendation given by the Board of Auditors the internal audit function now consists of one Senior Auditor and one Auditor. The Board of Auditors monitored management responses and proposed resolutions of the matters raised.

The ESM's internal audit performed a number of audits, on matters such as business continuity, asset and liability management, outsourcing controlling, funding as well as investment and treasury. ESM's internal audit evaluated the adequacy, effectiveness and timeliness of actions taken by ESM's management on findings and recommendations including recommendations made by the Board of Auditors and the external auditor.

The results of the internal audits are reflective of the development stage of the ESM and show progress in the design of standard practice controls. The internal audits still flag some lagging in implementation. The Board of Auditors recommended that the ESM intensifies its efforts to close findings in a timely manner.

The ESM introduced an audit clause which has now been included in the service level agreements with two key suppliers. Based on this clause the internal auditor of the ESM is now able to conduct audits of the suppliers. The audit clauses for three other key suppliers are still under discussion.

## 4.4. FOLLOW-UP OF THE RISK MANAGEMENT AUDIT

The Board of Auditors carried out an audit of risk management at the beginning of 2014. The audit covered different aspects of risk management; the aim was to obtain an overview of the design of the ESM risk management system as well as the policies and guidelines. The main findings and recommendations have been reflected in the previous annual report of the Board of Auditors.

In February 2015 the Board of Auditors conducted a follow-up audit to verify the actions taken by the ESM.

Both audits were in accordance with Article 30 (3) of the ESM Treaty. In line with Article 24 (5) of the ESM By-Laws, the Board of Auditors appointed subject matter experts to support the audit work.

The main results of the follow-up audit are as follows:

- The Board of Auditors notes that the ESM has made progress in implementing an adequate risk management organisation: Staff is now assigned either to the first line or the second line of defence. Nevertheless legal and reputational risks are covered by departments belonging to the first line of defence whereas the function of Chief Risk Officer covers the oversight and control for all risks across the ESM. To address this, the ESM has to ensure that the Chief Risk Officer function is an integral part of all risk management processes. This role should be reflected in dedicated legal and reputational risk processes as well as risk management policies.

- In 2014 the ESM implemented a number of risk management elements and policies. Nevertheless certain risk management elements and risk policies are still outstanding and should be implemented such as holistic stress testing, key risk indicators for operational risk monitoring, market risk and liquidity risk policies.

- The first annual risk management self-assessment has been completed. ESM identified several risk areas for further development and should address them.

## 4.5. AUDIT OF LENDING OPERATIONS

In 2014 the Board of Auditors carried out a first audit of ESM´s lending operations. Based on Article 24 (5) of the ESM By-Laws the Board of Auditors appointed subject matter experts to support the audit work.

The audit covered disbursements by ESM and the monitoring of granted support. The work of the Troika was not part of the audit.

The ESM followed most of the recommendations given by the Board of Auditors. Nevertheless the Board of Auditors would like to address the following:

- According to the ESM Treaty (Article 13) the ESM has to establish an "appropriate warning system" to ensure that it receives any repayments due by the beneficiaries in a timely manner. Hence the ESM has implemented an Early Warning System (EWS) after it was approved by the Board of Directors in 2014.

- The EWS concept – as it is implemented by the ESM – focusses on the next upcoming payment date. It would be appropriate to cover the intermediate- and long-term perspective going beyond that date as well.

- EWS reporting is triggered by payment dates only. As these dates are up to 10 months apart, the Board of Auditors recommends timely reporting. The ESM is supposed to ensure at least quarterly reporting.

- The ESM should implement all required EWS elements such as loss forecasting and stress testing.

# 5. In closing

The ESM, for the period under review, was in its second year of full operation. The Board of Governors is invited to consider the findings and recommendations mentioned in this Annual Report and to undertake appropriate initiatives.

Berlin, 13 May 2015
Board of Auditors